Ashmore

EM assets well supported amidst 'Draghi tantrum'

By Gustavo Medeiros

The Czech National Bank confirmed that rate hikes are on the way. China launched the China-Hong Kong Stock Connect today as China manufacturing activity surprises to the upside. Brazil cuts the 2020 inflation target to 4%. Argentina's economy surprises on the upside. Colombia cut rates by 50bps. Turkish tourism rebounds. Thailand moves to fast track infrastructure investments. In the global backdrop we argue that Emerging Markets assets are likely to be well-supported despite an increase in volatility caused by what seems to be a coordinated hawkish turn by global central banks, the so-called 'Draghi tantrum'.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	0.11%
MSCI EM Small Cap	11.9	–	0.19%
MSCI Frontier	10.6	–	0.63%
MSCI Asia	12.2	–	-0.11%
Shanghai Composite	12.5	–	1.17%
Hong Kong Hang Seng	7.6	–	0.05%
MSCI EMEA	9.4	–	-0.29%
MSCI Latam	12.4	–	2.22%
GBI-EM-GD	6.15%	–	-0.19%
ELMI+	4.25%	–	0.30%
EM FX spot	–	–	0.05%
EMBI GD	5.38%	308 bps	-0.39%
EMBI GD IG	4.15%	181 bps	-0.55%
EMBI GD HY	6.74%	451 bps	-0.23%
CEMBI BD	5.10%	292 bps	-0.06%
CEMBI BD IG	4.11%	194 bps	-0.13%
CEMBI BD Non-IG	6.51%	432 bps	0.05%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.7	–	-0.58%
1-3yr UST	1.39%	–	-0.04%
3-5yr UST	1.89%	–	-0.30%
7-10yr UST	2.32%	–	-1.14%
10yr+ UST	2.85%	–	-2.14%
10yr+ Germany	0.46%	–	-2.86%
10yr+ Japan	0.09%	–	-0.68%
US HY	5.62%	364 bps	0.28%
European HY	3.16%	349 bps	-0.21%
Barclays Ag	–	247 bps	-0.66%
VIX Index*	10.99	–	1.09%
DXY Index*	95.96	–	-1.47%
EURUSD	1.1386	–	1.82%
USDJPY	112.86	–	0.89%
CRY Index*	174.78	–	7.03%
Brent	48.9	–	6.76%
Gold spot	1236	–	-0.69%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

- **Czech Republic:** The National Bank kept policy rates unchanged as expected, but released a hawkish statement signalling a rate hike by Q3 2017 due to increasing risks to inflation. The economy is starting to run a bit hot in the Czech Republic. Wage growth was running at a rate of 5.3% yoy increase in Q1 2017 against a backdrop of strong GDP growth (2.9% yoy). The National Bank has generally been anticipating ECB decisions. It pre-emptively cut rates to the 0% lower band and pegged the CZK 5% weaker versus the EUR ahead of the ECB's (European Central Bank) quantitative easing. Recently, the National Bank has been unwinding the peg and allowed CZK to strengthen ahead of more hawkish rhetoric from the ECB. We continue to believe that that National Bank is a good bellwether for the ECB, which in turn impacts the behaviour of the EUR.
- **China:** The China-Hong Kong Bond Connect was launched today. This creates yet another means whereby foreign investors can access China's large domestic bond market. Under Bond Connect foreign investors will have significantly easier access to the market. There is no quota and no investment plans need to be submitted. Investors will also be able to use the custody and clearing services of the Hong Kong Monetary Authority (HKMA), including using global custodians provided these are existing members of HKMA's central money market unit. Funds invested in Chinese bonds will remain in Hong Kong and will trade in CNY. Finally, settlement has been lengthened to t+2 in line with international conventions. Hedging with onshore interest rate derivatives is likely to be approved at some stage in the future. We believe that the net effect of the China-Hong Kong Bond Connect is to bring China's large bond market closer to inclusion in major global bond markets. In other news, China industrial profits continued to rebound as producer prices inflation picked up. PMI (Purchasing Managers' Index) numbers also surprised on the upside, rising from 51.2 in May to 51.7 in June with high technology and equipment sectors being the main contributors. The current account posted a surplus of USD 18.4bn and the capital account generated net inflows of USD 39.3bn in Q1 2017.
- **Brazil:** The National Monetary Council lowered target inflation rates. The 2018 target was maintained at 4.5%, but the 2019 target rate was reduced to 4.25% from 4.50% and the new 2020 target was set at an ever

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Emerging Markets

lower 4.00%. Inflation expectations for 2019 are already around 4.25%, so markets have been anticipating the new lower inflation target. Even so, inflation expectations should now decline further to reflect the new 2020 target. The reduction in the inflation target also has an impact on the expected fiscal path as the fiscal rule implemented last year links increases in expenditures to inflation. Hence, a lower inflation target should foster a decline in nominal spending, thus adding further urgency to the need to pass the planned pension reform. In political news, President Temer has been indicted by General Prosecutor Janot, but we think the opposition is unlikely to achieve the two thirds majority in parliament which is required to take the process forward. Janot has at least two further indictments against Temer, which he has yet to submit, so the pressure on Temer is likely to remain high. Even so, we believe stronger evidence of wrongdoing needs to emerge for the wider public to take to street protests in meaningful numbers. Without strong pressure from the general population, we do not see parliament acting on the accusations. In fact, we expect the Senate to approve a pending labour market reform this month after a favourable vote in a key Senate committee. In a negative development, however, the primary deficit deteriorated from 2.3% of GDP in April to 2.5% of GDP in May due to continuous deterioration in revenues, which declined by 1.2% in real terms, and front-loading of expenditures. We expect the government to increase taxes on gasoline and diesel in order to try to achieve this year fiscal deficit target (BRL 139bn).

- Argentina: Industrial production in Argentina surprised on the upside by expanding at a rate of 2.7% yoy in the month of May. The construction sector had a particularly strong rebound (10.3% yoy). The current account deficit widened to USD 6.9bn in Q1 2017 from USD 4.6bn in the previous quarter, thus taking the annualised deficit to 3.0% of GDP. The capital and financial account posted a large USD 18.1bn surplus driven by USD 16.5bn of portfolio inflows following large net bond issuances from both sovereign and provinces over the quarter. The central bank kept the policy rate unchanged at 26.25%. The stronger numbers may give the Macri administration an opportunity to accelerate the reduction in subsidies and allow a more depreciated exchange rate in a bid to re-balance the fiscal and external accounts. However, no major policy interventions are likely ahead of the mid-term elections scheduled for October this year.

- Colombia: The central bank cut the policy rate by 50bps to 5.75% in a split decision, which saw three of the seven policy committee members vote in favour of a smaller 25bps cut. The committee acknowledged that the benign environment for food prices could start to reverse in H2 2017, but expect general inflation to decline further towards the target as activity continues to surprise on the downside. Indeed, the committee therefore saw the odds favouring a downside surprise to its 1.8% growth forecast. With core inflation still tracking above 5%, inflation expectations still above the 3% target for 2018 and large twin fiscal and external deficits, the committee MPC runs the risk of increasing macro-economic instability if medium and long term inflation expectations are not well-anchored.

- Venezuela: A helicopter allegedly dropped three grenades onto the Supreme Court. The pilot, Oscar Perez, a former captain of the country's intelligence and investigative body, released a series of videos on the internet in which he assumed responsibility. Perez urged the population to stand tall against what he called a "criminal government". President Maduro wasted no time in accusing Perez of terrorism and implored Venezuelans to fight to defend the revolution with the words: "what we failed to achieve with votes, we would do with weapons". Others claim that the attack never took place given that the air force never responded. Even so, this incident underlines the desperate state of politics in Venezuela following the decisions of Chief Prosecutor Luisa Ortega Diaz and former interior minister Miguel Rodriguez Torres to break with the government. These developments will give further incentive for the opposition to push harder for a political transition. We believe, however, that much larger numbers of protesters will be needed before a political transition can be effected.

- Turkey: Tourism arrivals rebounded strongly last month as the political situation stabilised after the referendum. The broader economy is already showing signs of stabilisation. Unfortunately, we believe the current stabilisation is built on weak foundations as a state-engineered credit expansion is behind much of the improvement. Political tensions could mount in the future, but a stable economy in the short term should keep social instability at bay.

- Thailand: The military government has decided to use a provision in the country's Constitution to expedite infrastructure investments in a bid to accelerate the rate of economic growth. This is against the backdrop of the military government pledging to prepare the country for a return to democracy in late 2018.

- Malaysia: Prime Minister Najib is facing a new political challenge from an evolving crisis surrounding FELDA, an agricultural fund. Najib is already under pressure from his alleged involvement in the 1MDB scandal. FELDA's activities affect the livelihoods of core voters belonging to his United Malays National Organisation party.

- Mongolia: Democratic Party leader Battulga is leading in the polls ahead of a run-off election against Miyeegombyn Enkhold scheduled for 7th July. Battulga has 38.6% of voting intentions versus 30.7% for Enkhold's incumbent People's Revolutionary Party. A victory for Battulga could pose a threat to the Tavan Tolgoi coal project and opposition from shareholders including Chinese SOE interest groups.

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Snippets:

- Ecuador: Rating agency S&P downgraded Ecuador's sovereign credit rating from B to B- with stable outlook citing deterioration of the external and financial environment over the last twelve months.
- Chile: Unemployment inched up from 6.9% to 7.0% on the back of an improvement in the participation rate. Employment growth increased 1.7% in May.
- Mexico: The trade deficit widened to USD 1.1bn in May versus an expected surplus of USD 0.3bn. The unemployment rate dropped to 3.6% in May compared to 4% in the same month a year ago.
- India: The fiscal deficit for the first two months of 2017 was larger than expected at 4.4% GDP on the back of a strong acceleration of spending. The new Goods and Services Tax regime came into effect on 1 July, 2017.
- Poland: CPI inflation declined more than expected to a rate of 1.5% yoy in June from 1.9% yoy in May.

Global backdrop

Global bonds suffered a mini-tantrum last week when ECB President Mario Draghi stated that the Eurozone recovery is "strengthening and broadening" and that the full effect of the ECB policy on inflation will "gradually materialise". Despite the market reaction, this was hardly a hawkish message in our view. However, European bond markets have been trading at artificially high valuations for so long that a strong repricing was a clear risk. The German bund curve was heavily impacted with 2 year and 5 year rates widening 8 and 19 basis points, respectively. Nominal yields are still extremely low at -0.56% and -0.21%, respectively. Sudden changes in interest rates of the largest economy in Europe tend to impact the present value of bonds across the world, particularly when the move appears to be coordinated with the US Fed, the Bank of England, the Bank of Canada and the Czech National Bank all of which issued more hawkish statements.[1]

Why the sudden change of heart, given that inflation has recently been softening in developed economies? For example, US core PCE inflation surprised on the downside at 1.4% yoy in June. This is still far below the Fed's 2% target; inflation is also losing momentum in Europe and Eastern European countries. Oil prices are testing the lower bound of the 2016-17 range, so energy prices should take yoy inflation rates lower due to base effects.

In our view, the hawkish message suggests Central Bankers are more concerned with asset price bubbles than with inflation. Volatility has been eerily low for a while in a number of developed markets asset classes despite obvious deterioration in the political environment in both the US and UK. Geopolitical uncertainties have also increased in the Middle East and the Korean peninsula. The low level of volatility leads investors to continue to push equity valuations to new highs and credit spreads to new lows. Precisely such conditions were described as "irrational exuberance" by Alan Greenspan in December 1996 ahead of the Dotcom Bubble collapse in March 2000. On the other hand, the world economy is doing better due to the rebound in Emerging Markets (EM) economies and also more recently in Europe. Even Japan's economy is showing some signs of life as global trade recovered strongly in Q1 2017 despite protectionist noise from Donald Trump. Fiscal policy is likely to contribute to growth as well as defence spending rises in Europe and the US, while the UK seems on the cusp of abandoning a long-standing cap on public sector pay.

What will the more hawkish rhetoric from central bankers in developed economies mean for EM? In the 2013 tantrum EM suffered disproportionally vis-à-vis the developed world. This time is different. Firstly, EM countries are far less vulnerable than in 2013. For example, the aggregate GBI-EM GD weighted current account balance is now close to 0% compared to a deficit of 2.1% deficit in 2013. Secondly, currencies are more competitive and EM central bank policy rates (both nominal and real) are much higher across the board. Thirdly, inflation rates are declining in many EM countries despite stronger growth, thus allowing central banks to ease monetary policy, including in Colombia, Brazil, Chile, Peru, Russia and India. Others, such as South Africa and Mexico may be cutting soon. Eastern European countries are going in the opposite direction due to the influence of the German economy and ECB policy on their markets; we think this will push their currency higher against both the EUR and especially against the weakening US dollar.

As EM central banks cut interest rates and as DM central banks slowly tighten, investors should expect to make outright capital gains in EM local markets and outright capital losses in DMs. This should attract more capital from expensive DM bond markets into cheap EM bonds and thus push EM currencies even higher. Does that mean EM will be totally isolated if the current bond sell-off intensifies? No. However, it seems likely that EM will outperform even in a sell-off and then rebound much more strongly than DM markets. As such, investors should view temporary sell-offs as opportunities to invest.

[1] We drew attention to this change in sentiment on 19 June – see *'The worm turns'*, Weekly Investor Research, 19 June 2017.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.04%	18.55%	24.14%	1.41%	4.29%
MSCI EM Small Cap	0.79%	16.03%	17.25%	1.01%	5.38%
MSCI Frontier	0.64%	15.50%	19.28%	-3.42%	8.52%
MSCI Asia	1.62%	22.86%	27.01%	5.30%	8.27%
Shanghai Composite	2.97%	3.61%	11.07%	18.22%	9.96%
Hong Kong Hang Seng	-0.54%	12.48%	21.98%	3.74%	5.33%
MSCI EMEA	-2.19%	5.20%	13.51%	-5.40%	-0.93%
MSCI Latam	0.67%	10.32%	15.37%	-6.36%	-3.53%
GBI EM GD	0.46%	10.36%	6.41%	-2.80%	-0.67%
ELMI+	0.04%	7.21%	4.91%	-2.32%	-0.52%
EM FX Spot	-0.21%	4.42%	-0.25%	-9.17%	-6.83%
EMBI GD	-0.14%	6.19%	6.04%	5.37%	5.72%
EMBI GD IG	0.16%	5.72%	2.61%	4.33%	4.09%
EMBI GD HY	-0.43%	6.76%	10.06%	6.02%	7.89%
CEMBI BD	0.20%	5.01%	6.81%	4.80%	5.56%
CEMBI BD IG	0.26%	4.36%	3.85%	4.11%	4.72%
CEMBI BD Non-IG	0.12%	6.01%	11.63%	5.54%	7.09%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.62%	9.34%	17.89%	9.60%	14.60%
1-3yr UST	-0.08%	0.45%	-0.14%	0.70%	0.64%
3-5yr UST	-0.25%	1.23%	-1.18%	1.63%	1.20%
7-10yr UST	-0.59%	2.39%	-4.02%	2.83%	1.60%
10yr+ UST	0.40%	5.52%	-7.42%	5.64%	2.73%
10yr+ Germany	-1.90%	-3.85%	-10.75%	6.38%	5.63%
10yr+ Japan	-0.34%	-0.63%	-8.00%	5.39%	5.10%
US HY	0.14%	4.93%	12.70%	4.48%	6.88%
European HY	0.07%	3.35%	9.39%	4.76%	9.17%
Barclays Ag	0.02%	3.14%	2.84%	3.83%	4.47%
VIX Index*	-1.70%	-21.72%	-25.59%	6.49%	-34.03%
DXY Index*	0.35%	-6.12%	0.32%	19.63%	17.33%
CRY Index*	0.00%	-9.21%	-10.03%	-43.02%	-40.28%
EURUSD	-0.35%	8.23%	2.07%	-16.34%	-9.69%
USDJPY	0.44%	-3.54%	10.06%	10.44%	41.45%
Brent	2.11%	-13.89%	-2.82%	-55.92%	-51.40%
Gold spot	-0.43%	7.28%	-8.50%	-6.32%	-23.57%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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